STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON HUMAN RESOURCES
AND INTERGOVERNMENTAL RELATIONS

ON
THE RESTRUCTURING OF HUD'S
ASSISTED/INSURED MULTIFAMILY HOUSING PORTFOLIO

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Mr. Chairman and Members of the Subcommittee, thank you for this opportunity to present the views of the Office of Inspector General (OIG) on the problems facing the Department of Housing and Urban Development's (HUD) assisted/insured multifamily housing portfolio.

At the very core of HUD's creation and continuing mission is providing for decent, safe, and affordable housing for American families. Since the Congress created the Federal Housing Administration (FHA) in 1934, HUD and its predecessor organizations have administered a variety of Federal programs that have increased the supply and affordability of housing for millions of families. However, faced with shrinking resources and an increasing demand, Congress and HUD must find better ways to provide decent and affordable housing for low income families in need.

Many insured and assisted housing projects placed in service during the 1970's and 1980's for low income families are now staring at physical decline or have proven to be far too expensive. As I have testified before Congress on three occasions dating back as early as June 1994, prompt and sweeping action must be taken to deal with the Section 8 rental assistance contracts affecting these projects.

In my testimony this morning, I will provide OIG's perspective on program design flaws and HUD management deficiencies associated with the assisted/insured portfolio. As I will present later, these problems bring with them serious consequences for the tenants, their neighborhoods, and the Federal budget.

THE PORTFOLIO PROPOSED FOR REENGINEERING

As one of the Nation's oldest and largest financial institutions, FHA insures mortgage loans for about 15,800 multifamily rental properties with 2 million rental units which have an unpaid principal balance of about $47 billion. FHA insurance protects private lenders from losses resulting from borrower defaults on the mortgages for these properties. When a borrower defaults, the lender assigns the mortgage to HUD and receives an insurance claim payment from HUD for the unpaid mortgage amount. About 75% of FHA insured projects receive some form of direct subsidy from HUD in addition to mortgage insurance, including interest rate subsidies and/or Section 8 rental assistance. The project-based Section 8 subsidy is covered by contracts between HUD and the project owners. The owners agree to house lower income tenants in exchange for rent subsidies for specific units.

HUD's reengineering proposal applies to 8,636 properties that have both FHA mortgage insurance and receive Section 8 rental subsidies for some or all of their units. The Section 8 subsidy contracts for this portfolio will expire between 1996 and the year 2010. These properties have unpaid principal balances totaling almost $18 billion and contain about 859,000 units. Renewal of these contracts is expected to cost HUD approximately $42 billion in outlays during the next 7 years, and likely over $200 billion during the next 25 years. HUD reports that about 45 percent of this portfolio consists of older assisted projects with an unpaid principal balance of about $5 billion while the balance of the portfolio to be reengineered consists of newer assisted projects with an unpaid principal balance of $13 million.

Older assisted properties include those using Section 236 or Section 221 (D)(3) interest rate subsidies intended to subsidize rents for low income families. Many of these projects have a serious backlog of needed repairs affecting tenants and project viability. Over the years, the need for additional revenues in these projects was satisfied with Section 8 project based assistance.

Newer assisted properties include mostly projects insured under Section 221(D)(4) that receive Section 8 assistance on most or all units. Because Section 8 assistance for these projects is rather generous, most of these properties are in better condition both physically and financially when compared to the older assisted properties.

PROBLEMS AND CAUSES OF A TROUBLED PORTFOLIO

The insured Section 8 portfolio suffers from several serious problems, including a declining physical condition, expensive rental subsidies provided by the Federal Government, and a significant financial risk to FHA from mortgage insurance claims. We believe these problems are the result of two basic problems: first, the flawed design of the project based Section 8 program, and secondly, management weaknesses within HUD.

FLAWED PROGRAM DESIGN

The coupling of mortgage insurance and Section 8 project based rental assistance is flawed in its design and inherently risky. Insured Section 8 projects are not subject to the system of market disciplines and incentives that promote efficient and effective operation of rental housing.

Under FHA's insurance program, the Federal Government assumes almost all financial risk in the event of a default. Multifamily mortgage insurance programs require only a minimal equity investment (10%) for profit motivated owners which usually consists of noncash items such as fees and profit allowances earned during construction of the project. In the case of programs for refinancing existing projects, owners are allowed to withdraw their invested equity as part of the new mortgage proceeds.

Also, HUD insured mortgages are non-recourse, meaning that individual owners are not personally liable for the mortgages in the event of default. So, with minimal upfront investment or risk and HUD often willing to protect its investment in the property with more subsidies, owners often have little to gain by keeping down costs and protecting the interest of tenants. The overall insurance claim rate to FHA for the Section 236 program from inception is about 20%, while the claim rate for the Section 221 (d)(3) program is about 40% since inception.

Project based rental assistance becomes the primary source for meeting the growing financial needs of the projects. A disturbing number of projects are experiencing deterioration and neglect by their owners. A recent study performed by HUD reports that the insured Section 8 portfolio is in need of $3.7 billion in deferred maintenance. Owners often do not have built-in incentives to maintain properties because of a lack of equity investment and/or depleted tax benefits. If the rents are set too low, the project deteriorates and the tenants suffer and HUD risks paying an insurance claim. If the rents are set too high, the excessive subsidies pay for the windfall profits of the owners and deprive other needy families from receiving assistance.

Over one half of the projects in this portfolio have rents being subsidized at levels 120% or more above local market levels. For the newer assisted projects, these rents will continue to escalate with automatic increases every year regardless of need. As operating and repair costs rise on older assisted projects, so do Section 8 costs because of the need for additional subsidized units or higher Section 8 rents to pay for the added costs.

Unlike tenants paying market rents, subsidized families living in units receiving project based assistance are forced to remain in their units, regardless of the quality of the housing, because they cannot afford to relocate to other available housing which is not subsidized. Families become trapped if they are to continue to receive assistance and are dependent upon HUD's ability to ensure the quality of the housing.

Program design also impedes enforcement actions for substandard performance or deliberate noncompliance with HUD's program requirements. Enforcement actions often have collateral effects upon the tenants and Federal spending as HUD attempts to employ corrective actions. Typically HUD's hands are tied because effective enforcement actions trigger other events that are not in HUD's interest, such as:

** If HUD declares a default of an insured mortgage, this results in acceleration of the debt by the mortgagee, the payment of a claim from the FHA insurance fund, and a lengthy and expensive disposition process.

** If HUD defaults a Section 8 contract, this results in a recapture and rescission of the contract authority. However, the subsidized tenants are then left without affordable housing.

** If HUD abates the Section 8 payments on a significant number of units in an insured project, the cash flow decreases, the owner cannot pay the mortgage or repair the units, the residents continue to live in unacceptable housing and HUD pays a claim from the insurance fund.

** If HUD decides, as a last resort, to foreclose on a project because the owner refuses to take needed corrective actions, the owner quickly hides behind Bankruptcy Act protections to delay HUD action, and thus costing HUD more as the project continues to deteriorate. When HUD does eventually foreclose, acquire and then sell the property, yet more Section 8 is placed on the property. All this while tenants continue to live in substandard housing.

Another major problem in HUD's multifamily insured housing programs is the issue of equity skimming. Equity skimming plays a significant part in the realization of losses to the FHA insurance funds. Equity skimming is the willful misuse of any part of the rents, assets, income or other funds derived from the insured property.

Apart from the fairly obvious financial losses that HUD incurs when owners collect rents but do not pay the mortgage, equity skimming generally has other insidious implications. Most notably, living conditions deteriorate for the tenants as funds intended to maintain, replace or repair living units are diverted for the personal use of owners.

The reasons some owners violate HUD requirements and divert project funds are multi-faceted. The reasons range from simple greed to more complex issues associated with the tax laws. The bottom line remains, however, that when an owner chooses to misuse project funds, it is almost always with the idea of personal enrichment and with little worry that if and when caught, any meaningful consequences will be paid.

Once an owner gets into the "nothing to lose" position with a project, HUD must be able to promptly identify project abuse and take the steps needed to minimize the impact on the tenants and the insurance funds. HUD has not been able to respond in this manner. HUD Field Offices do not have the resources and systems to adequately assess troubled projects and take effective loss mitigation actions.
In effect, the majority of risk involved in these projects is taken by the tenants and the taxpayers. Tenants are seemingly trapped when project conditions deteriorate because their subsidies are tied to the units they occupy and tenants have rarely been able to obtain corrective actions by the owners. Taxpayers are often asked to pay for deteriorated units with excessive subsidies and to fund losses when insurance claims are paid.

As part of Operation Safe Home, the OIG has initiated an aggressive proactive effort to pursue affirmative litigation against owners of multifamily housing projects whose owners misuse project operating funds. The goal of Operation Safe Home is to stop major abuses in HUD programs that result in unacceptable living conditions for the millions of needy people who look to HUD for help. A primary objective of the Equity Skimming aspect of Operation Safe Home is to create an enforcement program that provides an effective deterrent and recovery mechanism for the misuse of income and assets at projects having HUD insured or Secretary-held mortgages. This effort is producing results. In the first 2 years, 10 criminal convictions and over $37 million in judgments, settlements, and fines involving project owners and managers have taken place. Another 105 cases are in process involving over $105 million in misused project funds. However, much more still needs to be done in program enforcement.

HUD WEAKNESSES

Serious problems with FHA management and practices have been the subject of studies, task forces and hearings for the last 20 years. As reported over and over by OIG, GAO and others, HUD's resources for the servicing of the insured multifamily portfolio are seriously deficient. HUD lacks the capacity to manage and monitor its portfolio of insured and assisted multifamily properties.

In fact, since 1987, HUD has been reporting the area of multifamily loan servicing as a "material weakness" pursuant to the Federal Manager's Financial Integrity Act. Our semiannual reports to the Congress and our financial statement audits of FHA have consistently pointed out systemic weaknesses that impact HUD's ability to manage and monitor multifamily programs, namely, inadequate staff resources and data systems, and weak management controls.

To the credit of HUD managers and staff, a newly designed asset management strategy for the multifamily insured portfolio is in place for 1996 that should improve their capabilities for mitigating losses and reducing the incidents of substandard housing. However, when dealing with the program flaws inherent to the project based assistance programs, such strategies are severely challenged in making a significant difference overall.

Staffing Resources

HUD currently lacks needed staff resources to adequately service the loans and Section 8 contracts in a manner that adequately protects the interest of the tenants and the Federal government. The staffing problems at HUD will likely worsen with the projected decrease in staffing in the Agency expected during the next few years. The skill level of the HUD staff generally does not enable them to effectively identify and assess physically troubled projects, and ensure corrective or enforcement action is taken.

For example, Field Office physical property inspections, financial statement reviews, and on-site management reviews have not been performed in a manner that consistently identifies problems. In addition, follow-up with property owners and their management agents is not sufficient to ensure that problems identified through HUD's monitoring are being addressed in a timely and acceptable manner. This often contributes to insurance claims, unacceptable housing conditions, and excessive and wasteful subsidies.

In April 1993, we issued a multi-region audit report covering HUD's servicing of insured/assisted multifamily housing projects. As part of our review, we inspected 28 troubled multifamily housing projects under the jurisdiction of six HUD Field Offices and determined that the physical condition of 23, or 82 percent, was unsatisfactory or below average. Of the 28 projects inspected, we determined that

20 had inadequate preventative maintenance programs. Our tests also showed that HUD staff had not performed any recent Housing Quality Standards (HQS) inspections for 17 (61 percent) of the 28 projects we inspected.

The audit also disclosed that HUD-insured multifamily projects remained in poor physical condition for extended periods of time and that units receiving Section 8 assistance often failed to meet HUD's housing standards. With respect to the latter, we inspected 314 Section 8 assisted units and determined that 216, or nearly 69 percent, failed to meet HUD's housing standards.

We reviewed the staffing level at the 6 HUD field offices included in the audit, and found that the workloads of the loan servicers widely varied from an average of 105 projects per servicer in Detroit to 28 per servicer in Kansas City. The average for the 6 offices was 57 projects per servicer. In addition to their loan servicing duties these staff had also been assigned additional duties to administer newer programs such as the Preservation Programs (Titles II and VI), monitoring State Housing Finance Agencies, along with other functions transferred to the field from Headquarters such as foreclosures, review of proposed project sales, and workout agreements.

Another factor hampering performance was the skill level of the loan servicing staff. Managers and staff must maintain a level of competence that allows them to accomplish their assigned duties. Managers in three of the six offices included in our audit reported that their staffs were not adequately trained to perform their jobs. We also learned that 4 of the 6 offices did not have any financial analysts on their staffs. Much has been done by HUD in the last few years to design and conduct training for loan servicers. However, budget constraints on HUD will continue to impact this area.

The high project to servicer ratio, the added responsibilities, and lack of training hampers the servicers' ability to prevent or remedy problems. In the search for yet new product lines and larger market shares, FHA staff can expect to be further burdened with new loans to service and new programs to learn. For example, the Secretary has decided to make health care facility financing, including mortgage insurance for hospitals, nursing homes and community health centers an important component in his recent plans to transform HUD. These and other programs distract HUD from improving the delivery of its core programs for providing decent, safe and sanitary housing for low-income persons.

Another demonstration of the scope of HUD's staffing shortages in this regard was contained in a 1993 Price Waterhouse audit report on FHA. That report pointed out the wide disparity between staffing levels at HUD and at other entities involved in multifamily housing lending. Whereas state housing finance agencies have staff/loan ratios of 1 to 20 and private institutions of 1 to 15, each HUD staff person has an average workload of 50 loans. Price Waterhouse went on to point out that HUD loans are typically much riskier, more troubled and thus more staff intensive, making the noted disparity even greater.

Management Controls

Management controls in the form of supervision and performance measurements have not been effective in ensuring that the mission and objectives of HUD's loan servicing function are being properly carried out.

The use of performance measurements is relevant to the administration of HUD's multifamily mortgage insurance programs for determining whether what is being done is making a difference. Our audit of loan servicing activities in 1993 disclosed that 5 of the 6 offices examined did not measure the performance of loan servicing qualitatively. HUD's measures used for evaluating performance in its multifamily programs focused on such activities as the amounts of funds expended, units subsidized, on-site reviews performed, management reviews completed and physical inspections performed during the year. Although 5 of the 6 offices achieved the goals established for them during the year, their success in correcting project deficiencies was dismal. These offices could not identify for us those projects having substandard living conditions, the length of time projects remained in disrepair, or the amount of insurance claims paid for the last 3 years or even the current year.

While recent OIG surveys of the Office of Housing's performance measurement and resource management found an improvement in the reporting of some program input and output measures, there is a continuing need for outcome measures and the use of performance measures in day-to-day program and resource management. The annual *Housing Management Plan* is the primary means of setting priorities and monitoring accomplishments. Field operating units set their own goals, and headquarters does not review the reasonableness of the goals relative to available resource levels and the volume and complexity of workload. Essential functions are still inadequately performed in many offices, such as reviews of subsidy payment requests, and follow-up and enforcement action on the results of contracted project monitoring activity.

In our audit of HUD's loan servicing activities, we also found that most financial reviews and on-site management reviews that we examined had no evidence of any supervisor review to ensure these assignments were properly performed by the staff. Supervisors attributed their lack of oversight to a lack of time and no established system requiring supervisory review.

Data Systems

The impact of staffing shortages could be offset somewhat through economies relating to the use of automated data. However, HUD does not have effective and integrated automated data systems that can be relied upon to provide relevant, timely, accurate, and complete information. Financial performance data on projects, while improving, continues to be inadequate. Data systems do not provide information usable for the early detection of troubled projects, and assessing and resolving project difficulties. Numerous past attempts to develop a useful system have not been successful. Management must establish accountability and responsibility for project management, technical support, data quality, documentation, and training. Inadequate data systems has contributed to fraud, waste and mismanagement in many of HUD's programs, including the Section 8-assisted multifamily housing programs.

GUIDING PRINCIPLES FOR ACTION

As can be seen very plainly from the many years of problems that have plagued insured Section 8 projects, drastic changes are needed in the way HUD provides housing assistance to low income families. The expiring Section 8 contracts for these projects and the sizable impact that renewals will have upon the Budget have brought these problems to the forefront. We commend HUD for recognizing this problem and for their work in trying to develop a solution during the last 2 years.

Even as the budget crisis comes upon us, however, real progress toward achieving an agreed upon solution appears exceedingly slow. There seems to be agreement that this system of assisted/insured multifamily housing is costing too much. But there is concern that moving away from the current system will mean losing this stock of "affordable housing"; place tenants -- many of them elderly -- in the position of fending for themselves with tenant-based certificates and vouchers; and force owners to pay substantial amounts of capital gains taxes. There is also significant anxiety about what the costs would actually be. This is turn relates to HUD's lack of good data on a project level; HUD's management inadequacies; HUD's understanding of private sector motivations and probable reactions to portfolio reengineering; and HUD's ability to work with third parties as partners in portfolio restructuring.

If the OIG had a silver bullet policy solution, I would offer it now. We don't, of course; but we do offer the following considerations, which we believe are essential to devising the appropriate policy.

Expiring Section 8 contracts provide an opportunity to implement new housing assistance policy that fits within the total welfare reform debate. Currently, HUD rental housing assistance benefits only one-third of the households in need in this country despite the billions a dollars expended each year. And HUD reports the number of households spending over 50% of their incomes for housing continues to rise each year. With the reduction of Federal funds available for welfare programs, the future looks bleak for those many in need. Transitioning from Federal assistance programs to self-sufficiency must be ingrained in to our housing assistance programs if there is to be any chance of having enough resources to benefit all the families who deserve help.

As discussed earlier, many of the project in the portfolio have rents in excess of the market and are in need of a great deal of rehabilitation. Clearly this is not a stock of affordable housing when the rents are neither affordable to private renters or the Federal government. Where housing is available at market rates, the need to preserve the housing as project based assistance should be closely examined before committing additional Federal support.

During the last two years, the debate over the usefulness of vouchers has continued without resolution. HUD reports that, in large part, tenant based assistance provides a good mechanism for meeting the housing needs of low income families. Yet, too often, there are examples of families that have found vouchers to be unusable. Some cases would indicate this form of subsidy does not provide the level of assistance needed to make available housing affordable, while others find landlords reluctant to accept vouchers because of the additional costs or burdens placed upon them by the Federal government when compared to renting to unsubsidized tenants. These problems need to be addressed.

The combination of mortgage insurance and housing subsidies leads to unbusinesslike stewardship and additional subsidies. Congress and HUD must develop programs that take full advantage of market forces to ensure the quality and cost of housing is reasonable. We must understand what brought us to this point and what factors are likely to influence the future of the portfolio. Keeping project based assistance programs in place while only reducing Section 8 payments by restructuring mortgages will not fix the problem. Rather this is just a shuffling of the cost of the program from one appropriation to another. Much more needs to be done.

HUD's difficulties in designing a proposal to deal with the expiring Section 8 contracts and in estimating the costs of its restructuring proposal are indicative of the inadequacies of its data systems and lack of information on rental markets and the condition of projects in its portfolio. However, HUD's recently completed study on a sample of the portfolio to be reengineered has been a significant step forward in arriving at answers to the many questions about reengineering the portfolio.

HUD's ability to service its multifamily portfolio has been totally inadequate over the years, as discussed earlier. Thus, there is the question whether HUD has the capacity to implement and carry out a much more higher complex endeavor as portfolio reengineering in an effective and timely manner. HUD's capacity will become even more strained with expected staff reductions due to budget cuts and HUD's propensity for developing new markets and product lines for FHA. Our Office has not conducted any in depth analysis of the numbers and types of personnel that would be required to effectively carry out the proposed restructuring. However, several successful mortgage sales by HUD offer some hope that FHA could complete portfolio engineering if it was patterned after the sales program. The use of contractors, consultants, and third parties will likely play an important role in the plan to reengineer the portfolio. Oversight of those participating in the process outside the government will require our full attention.